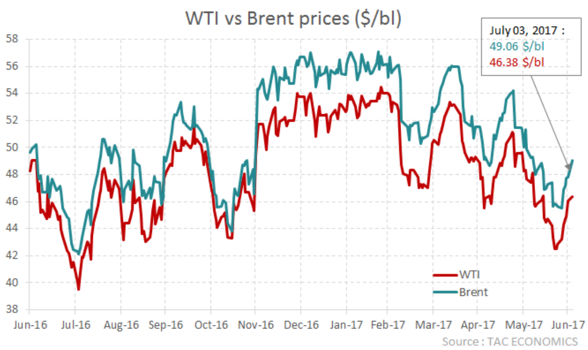
Oil prices: supply / demand rebalancing still under way, likely to push up prices back to 55-65$/bl before year-end

Oil prices (Brent) have declined by 16% between a peak of 57$/bl on Feb. 21, 2017 and lows registered at the end of June, before a sharp rise early July (49.03$/bl on July 3), raising question on the actual impact of the OPEC agreement to cut production. Our analysis and tools shows that large volatility should be expected in a context of lower but still excessively high inventories, but that the rebalancing between global supply and global demand is holding well despite resurgent US / Canadian output. Our quantitative models show a price-range of 42-55 $/bl (Brent prices) for the summer, followed by an upward move to the range 55-65 $/bl after September 2017 and until the end of 2018.

In parallel, the current political tensions, within the GCC and in / in-between many OPEC members are likely to reinforce short-term volatility, with sequence of worries on potential supply disruptions to symmetric questions on the ability of the OPEC agreement to hold. Last but not least, short speculative positions are close to their highest historical peaks, once again suggesting high volatility over the next weeks and months.

Oil prices (Brent and WTI), June 2016 to June 2017

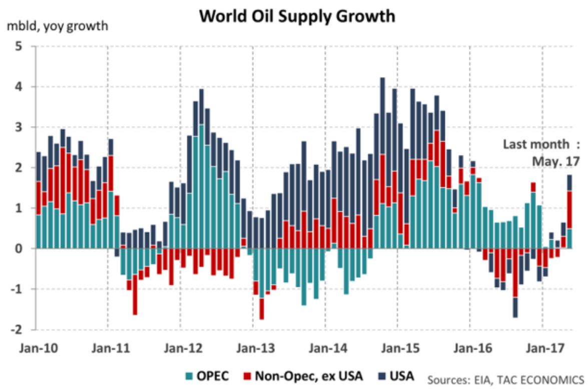


The decline in oil prices since 2017Q1 occurred despite the OPEC / Non-OPEC agreement to cut production.

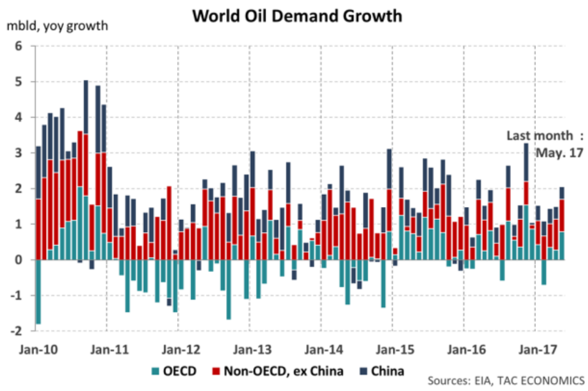
Global rebalancing between demand and supply is occurring

The observation of short-term change in supply / demand leads to the following observations:

1. OPEC members who were not included in the agreement because of specific supply disruption problems (Libya and Nigeria) have increased their production (+ 0.35mbd from Dec.16 to May17)
2. The coming on-stream of large previously-developed fields in non-OPEC producers (e.g. Brazil: +0.47mbd during the first 5 months of 2017), and a rebound in Canadian output after a temporary decline during 2016Q2 and Q3.
3. A rebound in US production, from 14.7mbd in Dec.16 to 15.4mbd in May17, as a short-term reaction to prices that stayed above 50$/bl during Nov.16 – Feb.17.



4. In parallel, the softness in US growth and mild winter in the Northern hemisphere have weighed down on demand from OECD countries during the first part of 2017.

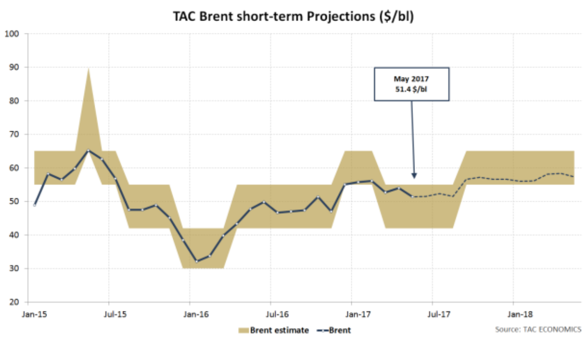


We believe that factor (4) is already dissipating, and factors (1) and (3) should stabilize at or very near current levels.

Regarding US production, the below 50$/bl average price over the past 4 months should pull back or reduce the future increases in output, as already suggested by the recent decline in number of rigs. We have however to take into account the potential impact of substantial cuts in production costs for US tight producers (below 45$/bl for most) and the "pushing" policy from the Trump administration.

In other words, the gradual rebalancing between demand and supply is still at work: even with the US increase in production, aggregate inventories have not increased and supply is still slightly below demand. Our set of non-linear models projecting oil prices up to 18 months ahead are now incorporating the observed OPEC / Non-OPEC production cut and discipline, as well as rising expectations for world economic activity. Overall, they show that prices are likely to remain in the "current" range of 42-55$/bl during the summer months, before moving the 55-65$/bl range later in the year and for most 2018.

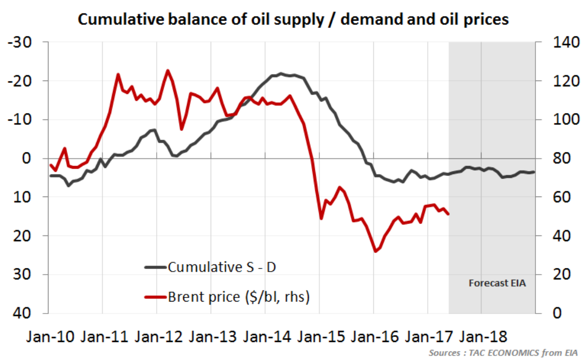
Oil price projection from datamining models



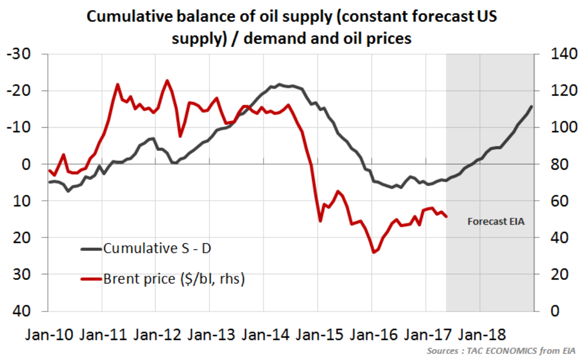
Inventories are very high, with "financial" factors becoming again more important

Inventories remain clearly "excessive" and the degree of rebalancing implies a long period for a substantial decline. A short-term model using such cumulative supply/demand for oil prices suggests that the mere stabilization of inventories at current levels supports price levels, and that a move to "normal" inventories would create a sharper upward move.

Using IEA forecasts, we find that indeed the level of inventories is expected to stabilize or reduce modestly over the next 18 months.



If we make an alternative assumption of seeing US tight oil production stabilizing because of the recent weakness in prices (instead of a rather large +1.76mbd increase expected for US production in the latest IEA projections), and keep the other IEA assumptions unchanged, we see a rapid move towards a more "neutral inventory level", implying a potential move above 60$/b… which would immediately trigger another period of higher US production.



Geopolitics and domestic politics are adding short- and medium-term uncertainty and volatility

As discussed in a previous Flash (Tensions in the Gulf, June 8, 2017), political tensions in the Gulf area are unlikely to disappear soon, and even our assumption of a Yalta-type of implicit agreement on influence-sharing between Saudi Arabia and Iran would not preclude regular bouts of "provocative moves". In the short run, political developments are likely to feed more volatility and speculative positioning, as potential supply disruptions are weighed against OPEC potential indiscipline.

The fundamental bottom line is therefore:

- Oil prices are likely to move back to above 50$/bl very soon, and in a 55-65$/bl range from 2017Q4 to end-2018;
- Volatility is expected to remain high, especially in the next few months;
- US tight oil producers are now the key "agile swing-producer" as long as prices do not move (durably) below 45$/bl, though OPEC and GCC producers remain key for supply adjustments if price collapse further.